



## Determining Board Governance and Control

### Issue:

This brief discusses the verification requirement concerning control of boards of directors.

(For purposes of this brief, Veteran applies equally to Service-Disabled Veterans; applicant refers to the business entity applying for verification; and participant refers to a business entity that has already been verified.)

### The Regulations:

**38 CFR § 74.4(a)** provides that “[c]ontrol means both the day-to-day management and long-term decision-making authority for the VOSB. Many persons share control of a concern, including each of those occupying the following positions: Officer, director, general partner, managing partner, managing member and manager. In addition, key employees who possess expertise or responsibilities related to the concern's primary economic activity may share significant control of the concern. CVE will consider the control potential of such key employees on a case-by-case basis.”

**38 CFR § 74.4(b)**, in pertinent part, provides that, “[c]ontrol is not the same as ownership, although both may reside in the same person. CVE regards control as including both the strategic policy setting exercised by boards of directors and the day-to-day management and administration of business operations. An applicant or participant's management and daily business operations must be conducted by one or more veterans or service-disabled veterans...”

According to **38 CFR § 74.4(f)**, “[o]ne or more veterans or service-disabled veterans must control the board of directors of a corporate applicant or participant.

(1) CVE will deem veterans or service-

disabled veterans to control the board of directors where:

- (i) A single veteran owns 100 percent of all voting stock of an applicant or participant concern;
  - (ii) A single veteran owns at least 51 percent of all voting stock of an applicant or participant, the individual is on the board of directors and no super majority voting requirements exist for shareholders to approve corporation actions. Where supermajority voting requirements are provided for in the concern's articles of incorporation, its by-laws, or by State law, the veteran must own at least the percent of the voting stock needed to overcome any such supermajority voting requirements; or
  - (iii) No single veteran owns 51 percent of all voting stock but multiple veterans in combination do own at least 51 percent of all voting stock, each such veteran is on the board of directors, no supermajority voting requirements exist, and the veteran shareholders can demonstrate that they have made enforceable arrangements to permit one of them to vote the stock of all as a block without a shareholder meeting. Where the concern has supermajority voting requirements, the veteran shareholders must own at least that percentage of voting stock needed to overcome any such supermajority ownership requirements.
- (2) Where an applicant or participant does not meet the requirements set forth in paragraph (f)(1) of this section, the veteran(s) upon whom eligibility is based must control the board of directors

through actual numbers of voting directors or, where permitted by state law, through weighted voting (e.g., in a concern having a two-person board of directors where one individual on the board is a veteran and one is not, the veteran vote must be weighted—worth more than one vote—in order for the concern to be eligible for VetBiz VIP Verification). Where a concern seeks to comply with this paragraph:

- (i) Provisions for the establishment of a quorum cannot permit non-veteran directors to control the board of directors, directly or indirectly;
  - (ii) Any executive committee of the board of directors must be controlled by veteran directors unless the executive committee can only make recommendations to and cannot independently exercise the authority of the board of directors.
- (3) Non-voting, advisory, or honorary directors may be appointed without affecting veterans' or service-disabled veterans' control of the board of directors.
- (4) Arrangements regarding the structure and voting rights of the board of directors must comply with applicable state law.”

**38 CFR § 74.4(g)(1)** provides that “[n]on-veterans may be involved in the management of an applicant or participant, and may be stockholders, partners, limited liability members, officers, or directors of the applicant or participant. With the exception of a spouse or personal caregiver who represents a severely disabled veteran owner, no such non-veteran or immediate family member may...[e]xercise actual control or have the power to control the applicant or participant...”

**38 CFR § 74.4(i)(1)** provides that “(n)on-veterans or entities may be found to control or have the power to control... [when]... [n]on-veterans control the board of directors of the applicant or participant, either directly through

majority voting membership, or indirectly, where the by-laws allow non-veterans effectively to prevent a quorum or block actions proposed by the veterans or service-disabled veterans.”

**38 CFR § 74.1** states that “[n]egative control includes, but is not limited to, instances where a minority shareholder has the ability, under the concern's chapter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders.”

## What This Means:

A single Veteran who owns 100 percent of the stock of a corporation is deemed to control the board of directors. However, besides ownership by a single Veteran, Veteran owners must always have the majority vote either by representation on the board of directors (which may vary depending on the facts), weighted voting, or block voting. A corporation with two directors (one a non-Veteran) may use weighted voting to show that the Veteran has the majority vote. Weighted voting is typically viewed as a system in which one board member's vote is weighted more heavily than another's member's vote, for example, by the number of shares (i.e., the Veteran's vote is weighted by the number of shares he or she holds as opposed to each director having just one vote per person). An applicant is not verifiable if non-Veterans can outvote the Veteran(s), prevent the establishment of a quorum by their absence, or in any way prevent the Veteran owner(s) from making strategic decisions related to management of the business.

## Extraordinary Events Exception

VA has interpreted a limited exception to the general control requirement. This exception, referred to as extraordinary events, is designed to protect minority owners' and investors' interest in the business. These exceptions

include (but are not limited to) acceptance of new capital contributions, material amendments to by-laws, issuance of additional shares of capital stock, and the sale or lease of all or substantially all of a business' assets. Unless there is a recognized exception, Veteran owners must always have the majority vote by representation on the board of directors, weighted voting, or block voting.

## **Examples of Lack of Control:**

### **Negative Control by Lack of Quorum**

- There are three directors—two Veterans and one non-Veteran. According to the company by-laws, the board of directors manages the corporation. A quorum for board meetings consists of a majority of directors, in this case, two of the three directors. If one of the Veteran directors of the business is unavailable for the meeting, the non-Veteran director has the ability to exert negative control over the Veteran-owners' ability to establish a quorum by not appearing, since it requires two directors to establish a quorum. Thus, the Veteran-owners have not demonstrated full control over the business as required by the regulations.
- There are two directors—one Veteran and one non-Veteran. According to the company by-laws, the majority of the directors constitute a quorum for a board of directors meeting. In this case, both the Veteran and non-Veteran directors must be present to establish a quorum. Consequently, the non-Veteran director can exert negative control by being unavailable to establish a quorum that requires both directors' presence at the meeting. Therefore, the Veteran does not control the business as required by the regulations.

### **Negative Control by Failing to Vote**

- According to the company by-laws, the board of directors manages the corporation. A quorum for board meetings consists of the majority of directors—and

the act of a majority of directors present at a meeting constitutes board action. With a two-person board of directors (i.e., one Veteran and the other non-Veteran), the non-Veteran director can exert negative control by abstaining from the vote and consequently, preventing board action. Therefore, the Veteran has not demonstrated full control as required by the regulations.

- According to the company by-laws, a majority of directors is required to establish a quorum. The corporation has three directors (i.e., one Veteran and two non-Veterans). Since a majority of directors is required to establish a quorum and there are two non-Veteran directors, the non-Veteran directors have the power to establish a quorum or transact business without the presence of the Veteran. The two non-Veterans may also prevent board action initiated by the Veteran. In this case, the Veteran has not demonstrated full control as required by the regulations.

### **Lack of Weighted Voting**

- The company by-laws state that the business of a corporation shall be managed by its board of directors. In the case where there are only two directors—one Veteran and one non-Veteran—and there is no provision for weighted voting or any other provision that would resolve a deadlock in favor of the Veteran, the firm fails to meet the requirements of the regulations as the non-Veteran director can block corporate action. Thus, the Veteran has not demonstrated full control as required by the regulations.
- Article II, Section 1 of the company by-laws states that "...all corporate powers shall be exercised by or under the direction of, and the business and affairs of the corporation shall be managed under the direction of, the Board of Directors." Article II, Sections 6 and 7 states that a quorum will be a majority of the directors and that the vote of a majority of the directors present when

a quorum is established will be the act of the board of directors. The articles of incorporation list the Veteran and the non-Veteran owners as directors of the company. There is no provision for weighted voting giving the Veteran director a majority vote for the transaction of business. Therefore, the business fails to meet the requirements of the regulations as the non-Veteran director can exercise control by blocking corporate action. Thus, the Veteran has not demonstrated full control as required by the regulations.

#### **Removal of Directors as Constituting Control of Board of Directors**

- Corporate by-laws, minutes, or shareholders' agreements that contain a provision that allow Veteran shareholders to remove one or more directors at any time and for any reason constitutes control of Board of Directors. Merely being able to remove a director at an annual meeting would grant a shareholder the ability to remove a director, but only once per year and would therefore not be sufficient by itself. Similarly, only being able to remove a director for cause would not be sufficient. In a case involving multiple Veterans, one Veteran must individually possess the necessary votes to remove a director or there must be evidence that the Veterans have entered into enforceable arrangements to permit one Veteran to vote the stock as a block.

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#### **VA Office of Small and Disadvantaged Business Utilization**

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